

Policy Working Papers

April 1989

Number 20

THE BATTLE OF THE BUDGET

by

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EXECUTIVE SUMMARY

President Bush's pledge not to raise taxes has intensified this year's budget debate. After his election, the press and Congress questioned both Bush and administration officials hoping to pry loose a concession that the president would accept a tax increase. Much to the chagrin of congressional big spenders, the president has kept his pledge reiterating his position that the federal deficit persists because of excessive expenditures, not because of insufficient revenue.

The budget issues this year are confusing because conservatives are saying that deficits have little impact on the economy and free-spending liberals are preaching that deficits are the root of economic decay. This paper points out that deficits, *per se*, are not the main problem. The more important economic issue is the relative burden of government spending on the private economy.

As a percentage of Gross National Product, the deficit has declined from 6.3 percent in 1983 to 3.2 percent this year. By next year, if the Gramm-Rudman-Hollings target is met, the deficit will fall to 1.7 percent of national income.

The real issue is not just balancing the budget, but deciding at what level of government spending the budget is balanced. For example, even though the United States was at war in the 1960s, federal expenditures as a share of national income averaged only 19 percent. In the peaceful period of the 1980s, however, government spending has averaged more than 23 percent of national income. Thus, the burden of public spending on the private sector has increased by more than 20 percent since the 1960s.

Recognizing the detrimental effects of excessive government expenditure, the U.S. Chamber of Commerce has proposed a fair and flexible freeze to limit the growth of federal spending. The fair freeze would leave Social Security alone, pay the interest on the national debt and increase the total amount of all remaining federal spending no faster than the rate of inflation. If the economy only achieves the postwar average rate of real economic growth since World War II (3.3 percent annually), the fair and flexible freeze will balance the budget by fiscal year 1993.

Increasing taxes to reduce the deficit would only make matters worse. One study cited by the Joint Economic Committee estimated that for every dollar Congress raised taxes, they increased spending by \$1.58 thereby increasing the deficit. Furthermore, raising taxes could cause a recession which would increase the deficit significantly. During a recession, the government increases spending while revenue is falling.

In addition to the fair and flexible freeze, serious budget reforms are needed to prevent reckless fiscal policy in the future. One of the most important reforms is a balanced budget requirement that would force Congress to plan budgets with zero deficits and would require a super majority of Congress to increase taxes. Another critical reform would be to abandon the current services baseline method of budgeting in favor of current level budgeting. Starting the budget process by looking at the preceding year's actual outlays would make it impossible for the press to characterize spending increases as cuts.

This paper concludes that the most effective policy prescription for deficit reduction is to restrain increases in federal spending and encourage strong economic growth.

The FY 1990 Budget

Once again in 1989, the budget process commands center stage. George Bush won the November presidential election on a pledge of no new taxes. Since then, Congress and the press have continually tested Bush's resolve. The new administration's every word has been scrutinized for hints that the president would be willing to break his pledge.

Early remarks by Office of Management and Budget (OMB) director, Richard Darman, sparked a debate about the definition of a new tax. Darman however, doused the debate concerning the assessment of revenue proposals with his famous duck test. (If it looks like a duck, walks like a duck . . .) Soon after, the spotlight shifted from Darman to Treasury Secretary Nicholas Brady who proposed a bailout plan for the savings and loans that included "user fees" for depositors. The public and congressional outcry over this proposal effectively closed yet another option to raise revenues. However, the tax issue has yet to be put to rest. Recent statements by the OMB suggest that some people within the administration might classify new taxes on employee benefits as no more than a "definitional change", not a tax increase.

Press accounts continued to insinuate that without revenue options, the president would be unable to propose a budget that would meet deficit reduction targets. Everyone eagerly awaited Bush's budget submission February 9. As promised, the budget called for spending restraint but not for any new taxes. In fact, the budget recommended lowering the capital gains tax rate.

With Budget Committee hearings that began February 21, the focus shifted to Congress. Attendance at the first Senate Budget Committee hearing was standing room only with almost every committee member present and lobbyists overflowing

into the hall. Ranking Republican on the committee, Senator Domenici, remarked that he could not recall a budget hearing that had such high attendance. Darman, the first and only witness that day defended the president's budget and reiterated that new taxes would not be needed to meet deficit reduction targets. Committee chairman, Senator Sasser, charged that the administration only appeared to meet these targets because they relied on overly optimistic economic assumptions.

To the average observer, the budget rhetoric this year appears complicated and confusing. Conservatives argue that economic growth will generate enough new revenue to balance the budget by 1993 without new taxes and that new taxes would only slow economic growth and the resulting flow of new revenue. Liberals argue that deficits are undermining the economy and that the budget can be balanced only by implementing new taxes. Meanwhile, the academic world remains divided on the issue. Nobel Laureate Milton Friedman, a conservative economist, has written recently that the impact of deficits on the economy has been overstated. Former Dukakis economic advisor, Lawrence Summers, contends that most major economic ills can be attributed to persistent deficits.

It is possible to understand what is really at stake in the budget debate by focusing on the forest rather than the trees. The deficit is no longer the main concern. As a percentage of Gross National Product (GNP), the deficit has declined from a high of 6.3 percent in 1983 to 3.2 percent in 1989. If the Gramm-Rudman-Hollings deficit target of \$100 billion is met for fiscal year 1990, the deficit will fall to only 1.7 percent of GNP.

The real issue is not just balancing the budget, but, more importantly, determining the level of spending at which the budget is balanced. At the individual level, in order to spend more, one must either earn or borrow additional money. Under our legal system, it is not possible to get something for nothing. At

the macro level, if outlays exceed revenue, the government may either raise new revenue, borrow or print money.

Nobel Laureate James Buchanan has championed the virtues of a balanced budget requirement. He argues effectively that if the government is permitted to spend the earnings of future generations, it will not face the same restraint as it does when it spends the earnings of the current generation because future generations are not able to vote in current elections. Many liberal policymakers have used this argument to justify raising taxes now in order to balance the budget and pay off the national debt.

What these liberal policymakers refuse to acknowledge, however, is that even if taxes were raised to balance the budget, Congress would simply increase the level of spending. Despite numerous tax increases since 1969, Congress has been unable to balance the budget in any year. One study cited by the Joint Economic Committee estimates that for every dollar increase in taxes earmarked to reduce the deficit, congressional spending increases by \$1.58.

The maximum deficit is set by the Gramm-Rudman-Hollings law. The only effect of a tax increase would be higher levels of spending since total spending is the sum of projected tax revenues and the allowable deficit.

For example, CBO projects that tax revenues will total \$1.069 trillion in fiscal year 1990. With a deficit target of \$100 billion, Congress can spend no more than \$1.169 trillion. Unless Congress raises taxes or changes the deficit target, the maximum allowable spending increase is \$37 billion in 1990. However, if Congress were to increase taxes by \$10 billion, the deficit would not fall; spending would increase by \$47 billion with the deficit remaining at \$100 billion, the maximum allowable level.

It is for these reasons that those concerned with economic prosperity expound the virtues of reducing the growth in federal spending rather than reducing the deficit *per se*. Raising taxes transfers real resources from the private sector to the public sector. Government borrowing also absorbs real resources since the source of government borrowing is private savings. If the government chooses to print money to cover a shortfall in revenue, real resources are still affected but less directly. The increase in the money supply eventually results in inflation, which erodes the real value of assets. With a government budget of more than one trillion dollars, the critical concern is not just whether the government finances additional spending by taxing or borrowing, but also whether placing the additional burden of public spending on the private economy threatens economic prosperity.

Throughout the 1960s, despite the Vietnam War and the Great Society programs launched by President Johnson, federal expenditures as a percent of national income averaged only 19 percent. Yet during the peaceful era of the 1980s, federal spending as a percentage of national income averaged more than 23 percent. In other words, the burden of public spending on the private sector has increased by more than 20 percent since the 1960s.

In his budget, President Bush correctly identifies the number one threat to our economic prosperity: the mushrooming burden of government spending on the private sector. His budget targets spending restraint as the highest priority budget action. Under the president's budget, spending as a percent of national income would fall to 19 percent, the same level as in the 1960s. Such a plan, if enacted, would encourage economic growth as tens of billions of dollars would remain in the private sector to create thousands of jobs and increase the standard of living. Bush's budget has three major components aimed at increasing our

economic prosperity: apply a fair and flexible budget freeze; do not increase taxes; and adopt major budget process reforms.

A Fair And Flexible Freeze

The U.S. Chamber of Commerce has proposed a fair and flexible freeze approach to budgeting that comports perfectly with President Bush's budget. The fair freeze is comprised of three components:

- Leave Social Security alone. Provide all benefits to existing beneficiaries and new entrants that are called for under current law, which includes upward adjustment in payments to compensate for inflation.
- Pay the interest on the national debt without relying on any reduction in interest rates. Interest rates may fall, but the plan is not dependent on it.
- Increase the total amount of all remaining federal spending no faster than the rate of inflation. This permits Congress to set priorities. Spending for some programs may increase faster than inflation and new programs may be created. The only constraint would be that spending on other existing programs must increase more slowly than inflation to compensate for any new spending and those spending increases for existing programs that exceed the rate of inflation.

If the economy does no better than achieve the postwar average rate of real economic growth (3.3 percent annually), the fair and flexible freeze will balance the budget by FY 1993. Even if the national economy falls short of the postwar average rate of growth by as much as 12 percent and manages to grow on average at only a 2.9 percent annual real rate, the fair and flexible freeze will still balance the budget no later than FY 1994.

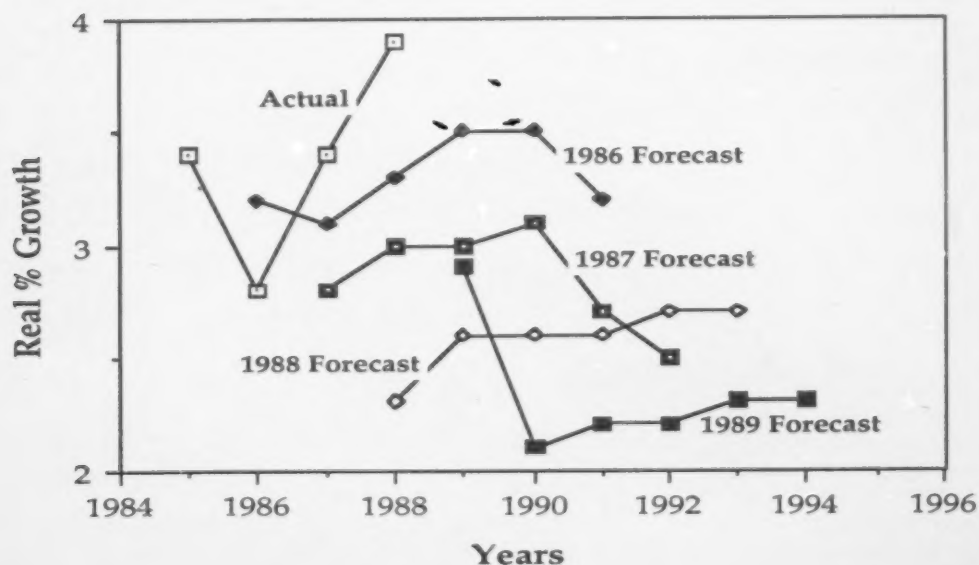
The Invalid Argument For A Tax Increase

The argument for a tax increase centers on the outlook for economic growth in the next five years. A fair and flexible freeze will balance the budget by 1993 if real economic growth is equal to the 3.3 percent average over the last 40 years. The

Congressional Budget Office (CBO) forecasts, however, that real growth will average 2.3 percent, substantially below the historical average. Under such a pessimistic scenario, the budget cannot be balanced by 1993 even under the fair and flexible freeze and consequently, tax increases would appear as the only solution for a balanced budget.

This line of reasoning does not justify a tax increase for three main reasons. First, CBO's real economic growth projections have fallen substantially below actual real growth in every year since 1984. CBO five-year projections are plotted in the graph below.

Actual vs. CBO Forecast Of Real Growth



From the graph it is clear that as actual real growth increased steadily through 1988, CBO forecast a dramatic downturn each year. The inaccuracy of these past CBO forecasts erodes considerably the reliability of their present projections. Macroeconomic forecasting remains an inexact science. The case for a tax increase

cannot be made on the basis of CBO's historically inaccurate five-year projections. Many forecasters, including the Federal Reserve and the U.S. Chamber of Commerce are forecasting considerably higher real growth than CBO.

The second reason new taxes are not justified is that the deficit as a percent of national income will continue to decline even if real growth falls below average. CBO estimates that the deficit as a percentage of national income will decline from 3.2 percent last year to only 1.7 percent in 1994 even if baseline spending is not cut and economic growth averages only 2.3 percent for the next five years. If spending growth is restrained below the excessively high growth rate built into the baseline and if real growth averages closer to 3 percent, the budget could be in surplus by 1994. Increasing taxes would only allow Congress to increase spending.

Finally, even if economists placed great faith in a pessimistic economic scenario, few if any economists would recommend increasing taxes if they expected a serious downturn in the economy. In fact, many would recommend just the opposite — a tax reduction. An increase in taxes would only worsen a declining economy, reduce the growth in revenue, and increase the size of the deficit.

Budget Reforms

One of the principal causes of the seemingly uncontrollable government growth has been the budgeting concept known as the current services baseline. According to OMB, the current services baseline answers the question: "What would the budget be if enacted budget policy were continued unchanged?" These estimates start with the current level of expenditure and augment this level to adjust for anticipated changes in economic variables such as inflation, economic growth, demographic and technical variables, and automatic provisions currently in the law to increase spending.

Using the current services baseline as a benchmark, huge increases in program outlays can be viewed as budget cuts. For example, outlays for Medicare will total \$86,778 million in 1989. The Reagan budget proposed increasing outlays to \$94,918 million for 1990 — an increase of more than \$8 billion dollars or 9 percent. Compared to the current services baseline estimate of \$99,955 million, the Reagan budget calls for a cut from the baseline in Medicare spending of more than \$5 billion or 5 percent. It is for this reason that many Americans believe that government spending was cut since 1980 when, in fact, spending increased by more than 80 percent between 1980 and 1988.

Congress and the media citing cuts from the current services baseline effectively hid ballooning government growth from the public. President Bush in his budget message called for an end to this kind of "wonderland budgeting." Senators Boschwitz and Nickles, following the president's lead, have introduced a bill to end "wonderland budgeting" (S. 447): "We can end it by imposing common sense on the federal budget and putting it on the same basis as every family budget: start with what was spent last year, and then decide how much we can afford to spend this year." Other budget reforms include a balanced budget and tax limitation amendment, line item veto, and enhanced rescission authority for the president.

Advocates maintain that Congress and the administration confront substantial barriers in limiting spending. In essence, the power of special interests is often too great to withstand. This is in spite of the many recent attempts to patch up the budget process. As a consequence, an outside "force", such as a constitutional balanced budget amendment, is needed to help Congress and the administration. Our elected officials will find it easier to face the special interests by saying that the Constitution requires a balanced budget. They can say "your plan to increase

spending must now compete with other plans for limited resources; we can no longer pass the cost onto the taxpayer."

The operation of a balanced budget amendment is relatively straightforward. The federal government would be required by the Constitution to balance the budget on an annual basis. This requirement can be suspended in times of war and, in most versions, by a three-fifths majority in both houses of Congress. Many versions contain some provision for suspension if the economy is in a serious recession. The U.S. Chamber of Commerce would only support a balanced budget amendment that contains provisions that make it difficult to use tax increases in meeting the goal by imposing a constitutional tax limitation or requiring a super majority for tax increases.

From George Washington to Richard Nixon, the president had the power to refuse Congress the spending money that it had appropriated for specific programs. Congress had no formal procedure to overturn such action. However, the Budget and Impoundment Control Act of 1974 eliminated this presidential prerogative and replaced it with weaker substitutes. In order to give the president greater ability to reduce spending growth, a line item veto and enhanced rescission power have been recommended.

A line item veto would allow the president to veto specific portions of a bill. Presently, the president can exercise only a veto over entire bills. The president is often reluctant to do this since Congress is in the habit of putting many items, some of which may be essential to his agenda, in a single bill. Moreover, Congress often bundles many appropriations bills in one large package called a continuing resolution. A veto of a continuing resolution can often lead to a government "shutdown" making it even more difficult to veto specific, inefficient projects.

Many constitutional experts believe that the Constitution has always provided the president with a line item veto. The president needs only to exercise this authority and let the courts decide if such action is in fact constitutional. Exercising a line item veto would rectify the inertia that now exists. The president could review programs on their own merits without being forced to "swallow" them as part of a larger package.

Congress, especially the appropriations committees, has been reluctant to grant the line item veto. It views the line item veto as a reduction in its discretionary powers. However, governors in 43 states possess such authority.

Another effective budget reform measure would be enhanced rescission power. Under present rescission rules the president can propose to rescind funds for specific programs. However, in order for the rescission to take effect, both houses of Congress must ratify it. If Congress merely abstains, the rescission is voided and the spending continues. Less than one percent of all presidential rescissions were acted upon by Congress during the last two years.

Enhanced rescission power would "turn the tables" by requiring Congress to vote against the rescission if they want to retain the spending program. As a consequence, Congress would have to go on record as favoring more spending than the president.

Conclusion

Restraining the growth in federal spending and encouraging strong economic growth comprise the most effective prescription for deficit reduction. A fair and flexible freeze will balance the budget by 1993 even if economic growth is modestly below the average real growth rate for the last 40 years. Increasing taxes would only increase government spending, slow economic growth, and postpone indefinitely

an eventual elimination of the deficit. Continued large increases in government spending as a percent of national income threatens our economic prosperity. Major budget reforms such as the balanced budget amendment, line item veto and enhanced rescission power offer the best hope for reducing government's burden on the private economy.

Policy Working Papers

August 1989

Number 21

CONCERNED ABOUT SAVING? . . . WHY NOT STOP TAXING IT!

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EXECUTIVE SUMMARY

"American are consuming too much and saving too little." This has been the most popular theme of a recent barrage of reports from numerous commentators. Observing the declining trend since the mid 1970s in the U.S. Department of Commerce personal saving rate, which reached a record postwar low of 3.2 percent of disposable income in 1987, those commentators contend that the critically low U.S. saving rate will ultimately lead to a decline in the American standard of living. Therefore, the trend in the saving rate must be reversed by immediately raising income taxes to increase federal revenue or by imposing consumption taxes to depress consumption.

In this policy working paper, the allegation that the saving rate is "too low" is examined by comparing the Department of Commerce measure of personal saving with other measures. The paper concludes that the Department of Commerce saving rate understates actual saving. Alternatively, the paper discusses two other measures of the saving rate -- the Federal Reserve individual saving rate and the total personal saving rate. The former indicates that the saving rate of the 1980s has declined slightly compared to that of the earlier decades since 1950. The latter suggests that saving has not fallen and is comparable to historical rates.

Therefore, the extent of the "saving crisis" hinges on the measurement of saving being used. Not only are tax increases unnecessary to increase the saving rate, they also would be harmful to the economy, especially at this time when the economy has become more vulnerable. Tax increases risk triggering a recession which would lower saving -- the very problem used to justify the tax increase to begin with. If promoting saving is the goal, instead of raising taxes, Congress should remove tax impediments, such as double taxation of dividends, a high capital gains tax rate and increased restrictions in contributions to retirement accounts, that currently exist in the tax code.

Introduction

A common thread now runs throughout most economic discourse in America: America is saving too little. No consensus, however, exists in the economics profession on the magnitude of suboptimal saving. Commentators tend to break out into two camps. One group contends we are so far short of the optimum level of saving that tax increases are urgently required to depress consumption and thereby increase household saving.^[1] They further argue that an increase in federal revenue generated by those tax increases reduces government dissaving and thus contributes to an increase in national saving. The other group contends that a shortfall in saving, if it exists, is not of crisis proportions.^[2] That shortfall mainly reflects biases against saving in the current tax code. Therefore, tax increases are neither necessary nor desirable. If Congress wants to encourage more saving, removing those biases against saving, not increasing taxes, is the solution.

This paper investigates the allegation that the saving rate is "too low" by comparing the U.S. Department of Commerce personal saving rate, a measure of saving most

[1] For example, in an open letter to the American Economic Association Members, well-known economists such as Benjamin M. Friedman, Lawrence H. Summers and Lester C. Thurow argue that a Value Added Tax is either the best way to raise any additional revenue or an acceptable second choice should income tax increases prove politically unacceptable (American Council for Capital Formation, Washington, D.C., 1989); also see Benjamin M. Friedman, "What Is the Right Amount of Saving?" *National Review*, June 16, 1989, pp. 25-26; C. Fred Bergsten, *America in the World Economy: A Strategy for the 1990s*, Institute for International Economics, Washington, D.C., 1988; Lawrence H. Summers and Chris Carroll, "Why Is U.S. National Saving So Low?" *Brookings Papers on Economic Activity*, The Brookings Institution, Washington, D.C., 2, 1987, pp. 607-35, and *Reclaiming the American Dream: Fiscal Policies for a Competitive Nation*, Council on Competitiveness, Washington, D.C., 1988.

[2] See, for example, Paul Craig Roberts, *Supply-Side Economics, Theory and Results: An Assessment of the American Experience in the 1980's*, The Institute for Political Economy, Washington, D.C., January, 1989 and Thomas C. Swanstrom, "The Savings Solution," *National Bureau of Economic Research Working Paper*, forthcoming.

frequently used by commentators, with other available measures. The conclusions drawn are:

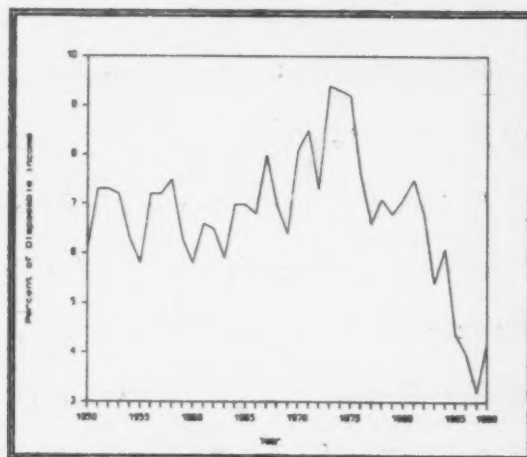
- Those who claim that a saving crisis exists often base their claim on the misleading personal saving rate that tends to understate actual saving.
- When other measures of saving rate are examined, the saving problem either appears exaggerated or may not even exist.
- The proper role of the government regarding saving is to minimize distortions of private saving/consumption choices by removing or minimizing biases against saving, such as double taxation of dividends, a high capital gains tax rate relative to the United States' trading partners and increased restrictions in contributions to retirement accounts.

How Little Is Too Little Saving?

The debate over the magnitude of the saving shortfall boils down to what measurement of saving is used. Proponents of the view that the saving rate is critically low rely on the U.S. Department of Commerce measure of personal saving as a percentage of disposable income and reject any other measures as more reliable indicators of saving. They point to the downward trend since the mid 1970s of the Department of Commerce personal saving rate which is calculated from the National Income and Products Account (NIPA) data as a residual of what is earned after tax, but is not consumed. To derive saving, statisticians must first measure disposable personal income by subtracting taxes from personal income. Then saving is calculated by subtracting consumer spending, interest paid by consumers, and transfer payments to foreigners from disposable personal income. Figure 1 shows the decline in the personal saving rates measured by the Department of Commerce. The personal saving rate reached a record

postwar low of 3.2 percent of disposable income in 1987, and then rose to 4.2 percent of disposable in 1988.

Figure 1 - Personal Saving Rate



Source: U.S. Department of Commerce, Bureau of Economic Analysis

Shortcomings in the Official Measurement

Those who assert that the current saving rate is not low compared to the historical trend argue that the Department of Commerce personal saving rate understates saving -- the total funds available for investment. Since saving is not calculated directly but as a residual, any error in the estimates of income, taxes, and consumer spending will result in distortions in the saving rate. The major criticism of this saving rate is that an expanding underground economy could cause it to decline because of the way in which income and consumption are measured. The bulk of wages and salaries reported in NIPA estimates comes from the U.S. Department of Labor wage surveys, and therefore, the

total income generated from unreported and illegal activity that contributed to the added saving is not included. Also, if a growing number of people, such as illegal aliens or drug traffickers, receive unreported income but continue to purchase goods and services, it will appear that people consume a higher proportion of their incomes than they really do, resulting in a misleadingly low saving rate.

Not only is this measure more prone to errors, but it also excludes many other forms of saving. For example, consumer durables, which constitute in some cases an investment in a tangible appreciating asset, are part of consumption in the NIPA; hence, personal saving is reduced by the value of outlays on these goods. An example is housing, whether owner- or tenant-occupied. If a high percentage of the population is in the age group that "consumes" housing, the measure of consumption will rise, and saving -- a residual -- again will fall. Thus, the saving rate is sensitive to changes in demographics.

The connection between the reported saving and the actual investment is fuzzy at best. By reporting saving as a residual and missing those items important as a reference to investment, the Department of Commerce personal saving rate underestimates saving that could be channelled into investment. When other available measurements of saving are examined, the saving problem, if it exists, appears exaggerated.

Other Measures of Personal Saving Rates

At least two broader measurements of personal saving exist. The individual saving rate is calculated from the "saving by individuals" data from the Federal Reserve (Fed) flow of funds accounts. It is based on information from financial institutions and estimates

of the amount of cash held by households. It includes increases in financial assets, net investment in owner-occupied homes, non-corporated business assets and consumer durables and net reductions in debt. The Fed measure is more than twice as high as the Department of Commerce measure, e.g., it stood at 11.9 percent of disposable income in 1988. The other broader measure -- the so-called total personal saving rate -- measures saving as the sum of Department of Commerce personal saving, personal and employer contributions for social insurance, and employer contributions for private pension, health and welfare funds.^[3]

Table 2 - Selected Personal Saving Rates

	<u>1980-88</u>	<u>1970-79</u>	<u>1960-69</u>	<u>1950-59</u>
Personal Saving	5.4	8.0	6.7	6.8
Individual Saving	11.8	13.3	12.2	12.6
Total Personal Saving	24.4	24.0	17.5	13.6

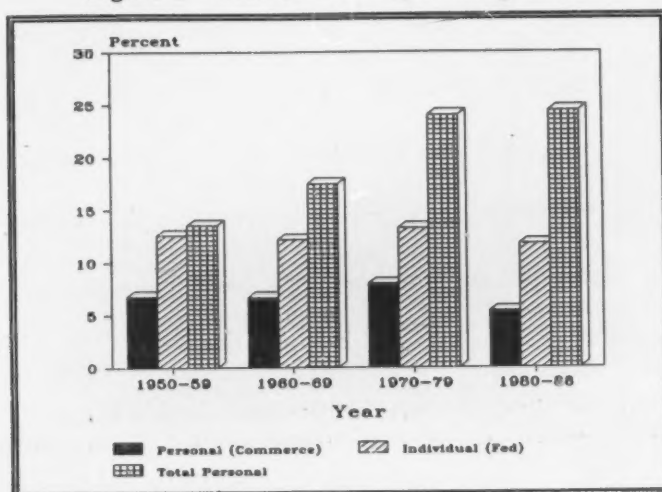
Source: The Federal Reserve Bank of St. Louis *Review*, April, 1989, p. 1.

Table 2 and Figure 2 compare the three personal saving rates in each decade since 1950. In sharp contrast to the behavior of the Department of Commerce personal saving rate, the two broader saving rates are not substantially lower in the 1980s, on average, than they were in prior decades. The individual saving rate has been only slightly below its prior

[3] Courtenay C. Stone, "National Economic Trends," *The Federal Reserve Bank of St. Louis Review*, April, 1989.

levels, while the total personal saving rate has slightly exceeded its earlier levels.

Figure 2 - Selected Personal Saving Rates



Gross Saving Rate

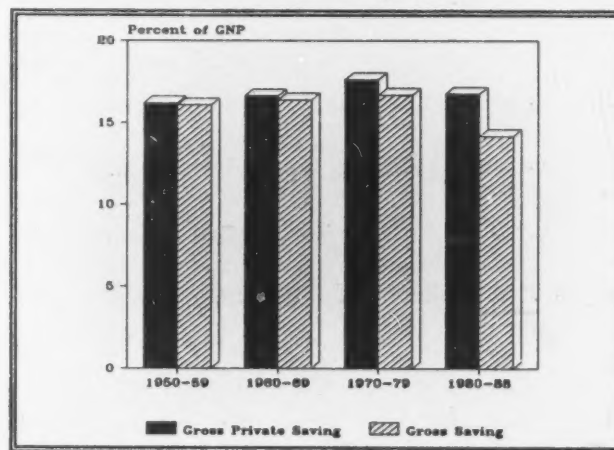
Some analysts point out that looking at personal saving does not give an adequate picture of saving. They suggest that a better way to reflect the total funds available for investment is to look at the broadest measure of the saving rate -- the national saving rate or the gross saving rate -- which is the sum of private gross saving and government saving as a percent of GNP.^[4]

The private gross saving rate, which consists of the household saving rate and the business saving rate, has been about the same in the 1980s as its average for the past thirty years, despite the fact that the personal saving rate component is misleadingly low. This is because the rise in business saving during the 1980s, resulting largely from faster

[4] See for example, Thomas C. Swanstrom, *op. cit.*

depreciation, has offset much of the decline in reported personal saving. The private gross saving rate averaged 16.7 as a percent of GNP in the 1980s, not much lower than the 1970s average, and a little bit higher than the 1960s and 1950s averages. On the other hand, the gross saving rate, which includes the government budget deficit, in the 1980s is two percentage points below that of the previous thirty years (see Figure 3).

Figure 3 - Gross Private Saving Rate and Gross Saving Rate



Source: U.S. Department of Commerce, Bureau of Economic Analysis

International Comparisons of Saving Rates

Since different calculation standards, accounting inconsistencies and socioeconomic factors prevail in different countries, any conclusion from international comparisons of the saving rates between the United States and other countries cannot be drawn without adjusting for differences in these factors. For example, the U.S. saving rate is usually compared to the Japanese saving rate because of the apparent difference between the

two reported rates. Those who compare the two rates and argue that the Japanese are more thrifty fail to mention that the U.S. national income account treats public investment as consumption, whereas Japan includes government non-military investment, such as infrastructure, as a part of gross saving.

If government non-military investment in Japan were unimportant, this difference in accounting procedures would not be as big of a problem. Despite the deficit in the late 1970s that represented five or six percent of adjusted net national product (NNP), Japanese saving was always positive because of the high rate of government investment, which constituted 8.4 percent of NNP in the 1970s, compared to 1.6 percent of NNP in the United States.^[5] Therefore, to make any international comparisons of saving between the United States and Japan without adjusting for differences in accounting methods is absurd.

Attempts have been made to adjust the two saving rates so that they are comparable. The results are such that the difference in the saving rates between the two countries narrows considerably. For example, after including consumer durables, government investment, and rental flow from the stock of consumer durables, net national saving rates in Japan and the United States were far less disparate than before, though the difference was still sizeable.^[6] Some argue further that if adjustments are made for international calculation standards (converting the U.S. Commerce Department system to

[5] Michael J. Boskin and John M. Roberts, "A Closer Look at Saving Rates in the United States and Japan," *American Enterprise Institute for Public Policy Research Working Paper No. 9*, June 1986, p. 17.

[6] Michael Boskin and John M. Roberts, *op. cit.*

the United Nations system), accounting inconsistencies (e.g., public pension is treated as government saving in the United States but as part of the private sector in Japan), and socioeconomic differences (e.g., higher home prices and higher down payment required for consumer durables in Japan versus easier credit in the United States and the tax structure in Japan that allows a much greater degree of relief from the double taxation of saving), the Japanese personal saving rate would exceed the U.S. rate by only a small amount, e.g., 2 percentage points instead of the publicized 12.4 percentage points in 1986.^[7] Thus, to argue that the Japanese save much more without adjusting for different factors that affect the measurement of saving is grossly misleading.

Therefore, the extent of the saving problem hinges on the measurement of saving used. The Department of Commerce saving rate reports a steep decline in the saving rate in the 1980s since saving is measured as a residual, and many items that should be counted as saving, such as capital gains and consumer durables, are excluded. The Fed "individual saving rate", which measures saving directly from the Fed flow of funds accounts, reports a slight decline in the saving rate in the 1980s since it includes those items that are excluded from the official measure. By contrast, the total personal saving rate suggests the saving has not fallen and is comparable to the historical rates.

U.S. Tax Structure Is Biased Against Saving

Regardless of the magnitude of the saving shortfall, if it is desirable to increase saving, it would be logical to increase rewards of saving by removing those biases that

[7] Kenichi Ohmae, "Is Japanese Savings Rate Too High," *Japan Economic Journal*, May 14, 1988.

already exist in the tax system. The 1986 Tax Reform Act contains many provisions that discourage saving and investment.^[8] For example, the tax code discourages savers who would like to channel their funds into stocks. Prior to the 1986 reform, capital gains were taxed at a fraction of the regular tax rate. Elimination of this favorable treatment in the 1986 tax bill, however, produced the largest capital gains tax rate increase in at least 50 years. A capital gain is the profit earned from a rise in the price of an asset at the time of sale. Since the price of an asset is the present value of its future income, the value of an asset will rise if the expected income from that asset rises. Capital gains are treated as income, even though they are not included as income in the NIPA. Table 5 compares international short- and long-term capital gains tax rates (excluding state, provincial and local taxes). The table demonstrates that the United States taxes capital gains more heavily than do most industrialized countries.

Furthermore, the United States is the only G-7 country^[9] that double taxes dividends. Others provide either full or partial relief from double taxation of dividends.^[10] U.S. corporations are taxed on profit at a rate of 34 percent, then shareholders are taxed

[8] This tax reform is designed to be "revenue neutral." It cuts marginal personal tax rates but increases the capital gains tax rate. It is argued that if the tax burden is shifted from households to businesses, net saving will not increase. While after-tax wages will increase, so will the after-tax cost of goods, both currently and in the future. See Patrick H. Hendershott, *National Bureau of Economic Research Working Paper No. 2553*, April 1988.

[9] The G-7 countries include Canada, France, Great Britain, Japan, Italy, United States, and West Germany.

[10] William S. Kanaga, "Corporate Debt, Mergers, Acquisitions and Leveraged Buyouts," *Statement of the U.S. Chamber of Commerce before the House Ways and Means Committee*, February 1, 1989, Appendix.

**Table 5 - International Comparison of Individual Taxation
of Capital Gains Tax Rate in 1989**

<u>Country</u>	<u>Maximum Capital Gain Tax Rates:</u>		<u>Period To Qualify For Long-term Treatment</u>
	<u>Short Term</u>	<u>Long Term</u>	
United States ¹	33.00%	33.00%	One Year
Australia ²	50.25	50.25	One Year
Belgium	Exempt	Exempt	None
Canada ³	17.51	17.51	None
France ⁴	16.00	16.00	None
Germany ⁵	56.00	Exempt	Six months
Italy	Exempt	Exempt	None
Japan ⁶	5.00	5.00	None
Netherlands	Exempt	Exempt	None
Sweden	45.00	18.00	Two Years
United Kingdom ⁷	40.00	40.00, indexed	None
Hong Kong	Exempt	Exempt	None
Singapore	Exempt	Exempt	None
South Korea	Exempt	Exempt	None
Taiwan	Exempt	Exempt	None

¹ The nominal tax rate for long- and short-term capital gains is 28%. The marginal rate, however, rises to 33% for joint returns between \$74,850 and \$155,370 and for single returns between \$44,900 and \$93,130 for calendar year 1989.

² Indexing is allowed on long-term gains.

³ Canadian residents are allowed an annual capital gains exemption of Canadian \$30,000 (\$22,998**) subject to a cumulative exemption of up to Canadian \$500,000 (U.S. \$383,300**) in 1990.

⁴ Gains from proceeds of up to 272,000 French Francs (U.S. \$45,288**) are exempt from taxation in a given taxable year.

⁵ The first 1,000 Deutsche Marks (U.S. \$554**) of short-term capital gains is exempt from tax.

⁶ Japan's tax reform plan, which takes effect in 1989, imposes a maximum tax of approximately 5% on the sale of securities.

⁷ Only gains and losses accrued since 1982 will be taxed; gains since 1982 are indexed.

** Based on exchange rates as of March 31, 1987.

Source: Prepared by Arthur Andersen & Co. for the Securities Industry Association in March 1987; updated by the American Council for Capital Formation, Center for Policy Research, March, 1989.

again at a rate as high as 33 percent on the same earnings when those earnings are distributed as dividends. When state taxes are considered, the effective marginal tax rate on distributed earnings can approach as much as two-thirds. In addition to raising the tax rate on capital gains and interest income, eligibility for individual retirement account (IRA) contributions has been sharply curtailed. Contributions to IRA, 401(k) plans and other corporate pension plans have been limited, and a penalty tax on retirement benefits above a specific level has been imposed. In the past, IRAs have played an increasingly important role in people's saving portfolios.^[11] Saving put into an IRA is subject to a "lock-in" effect, i.e., saving in such an account becomes devoted to long-term retirement needs and therefore is less likely to be spent until later.

The existence of Social Security also reduces the incentives to save for old age.^[12] Moreover, due to the 1983 Social Security reforms, increases in Social Security payroll taxes have further eroded the incentives to save. For example, under the reforms American workers will pay \$ 23.4 billion more in Social Security taxes in 1990 than they would have otherwise. The rhetoric surrounding the 1983 Social Security reforms reduce the incentives to save since workers are assured that the higher Social Security taxes they

[11] For evidence that IRAs create new saving, see, for example, Daniel R. Feenberg and Jonathan S. Skinner, *National Bureau of Economic Research Working Paper No. 2845*, February 1989.

[12] For one of the earlier discussions about the relationship between Social Security and saving see Martin Feldstein, "Social Security, Induced Retirement, and Aggregate Capital Accumulation," *Journal of Political Economy*, September/October 1974, Vol. 84, pp. 905-26. However, economists still disagree about the extent to which the existence of Social Security reduces saving. For a background on the subject and a review of previous empirical findings, see Douglas Bernheim and Lawrence Levin, "Social Security and Personal Saving: An analysis of Expectations," *American Economic Review Papers and Proceedings*, May 1989, pp. 97-101.

now pay are being "invested in their retirement." The clear implication is that individuals would not have to save as much for their own retirement. In reality, the "reform" which is a regressive surtax on income levied through the Social Security tax system is not generating any "reserve funds" since, under law, the Social Security Administration can only purchase federal government bonds with its surplus. Therefore, the Social Security surplus must be used to finance current government spending or debt retirement, and is not channelled to any investment in the private sector. In effect, these payroll tax increases force some reduction in personal saving without creating an offsetting increase in government saving.

Conclusion

Americans save just the way their income, wealth and expected return on saving over their lifetimes influence them. Instead of slapping their wrists by increasing taxes to penalize their consumption, the government should increase rewards for saving by removing unwarranted biases against it in the current tax code. What should worry citizens most regarding the current saving rate is the fact that many policymakers and so-called "leading economists" believe that a tax increase is a panacea for America's "saving crisis." The bottom line is simple: If Congress is really worried about saving, penalizing those who save is no way to show its concern.